State of California

Memorandum

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Subject: **TDC-SCPIE Acquisition**

I. INTRODUCTION

This is a follow-up to the March 21, 2008 memo to the California Department of Insurance ("CDI") regarding the acquisition of SCPIE Holdings, Inc. ("SCPIE") by the Doctors Co. ("TDC"). The purpose of this memo is to address two separate but related questions posed by "CDI" relating to the competitive impact of the acquisition. The first question is whether, under existing antitrust principles, the relevant market at issue here should include non-regulated alternatives to traditional medical malpractice insurance and "self-insurance." The second question is whether additional submissions from the Consumer Attorneys of California ("CAOC") and Compass Lexecon, TDC's economic expert, as well as data from CDI showing that TDC and SCPIE may have charged "excessive rates" from 2005 to 2007, alters this office's analysis of the merger dated March 21, 2008[1].

We believe that the relevant market in which to assess the competitive effects of this merger is fairly broad and includes both traditional medical malpractice insurance and alternative risk vehicles that effectively allow doctors to "self-insure" for some or most of their liability risks. It is, however, arguable under present antitrust principles, that purely self-insured entities like Kaiser can be eliminated from the product market.

Furthermore, as discussed below, this office does not believe that the new submissions mentioned above substantively change the original conclusion that the acquisition of SCPIE by TDC would not substantially lessen competition in the medical malpractice market. However, since TDC and SCPIE charged excessive rates under the current regulatory scheme, CDI could impose conditions upon the merging parties, including rate filings and rate roll-backs to protect California consumers.

[1] See Memorandum to Valerie J. Sarfaty, dated March 21, 2008 ("AG Analysis").

understanding competitive effects, and need not be measured by "metes and bounds."[11]

Taking the above principles as guides in defining the relevant product market in this case, and keeping in mind that it is "always possible to take pot shots" at a market definition, the evidence from internal company documents, public records, and interviews lead our office to conclude that the relevant product market in which to analyze competitive effects is the medical malpractice insurance and the non-regulated alternatives to traditional medical malpractice insurance market. Because the relevant product market in this case includes traditional medical malpractice insurance and alternative risk vehicles, the market share statistics quoted by CDI and CAOC overstate the merged firm's ability to exercise market power because it only include firms regulated by CDI. We therefore concur with TDC's economic expert, Compass Lexecon, in its May 20, 2008 letter to Commissioner Poizner, which stated that excluding entities such as CAP-MPT and risk retention groups[12] "biases any market share estimate and thus renders the HHI analysis presented by CAOC as unreliable for assessing the competitive effects of the proposed TDC-SCPIE merger."[13]

The question has been posed as to whether "self-insurance" belongs in the relevant market. To the extent that some market participants view "alternative risk vehicles" and "risk retention groups" as forms of self-insurance in that they allow members of such groups to pool their liability risks and eschew traditional medical malpractice insurance for most of their coverage, then arguably, these alternatives to medical malpractice insurance should be part of the product market.[14]

On the other hand, it is arguable, under the above cited antitrust principles, that entities that self-insure like Kaiser can be eliminated from the product market. It is arguable that doctors for the most part do not consider entities such as Kaiser to compete in the medical malpractice market per se, but as alternatives in terms of employment. But the parties to the merger would likely argue that as sellers of medical malpractice insurance, they view self-insured organizations that employ doctors as competitors, because every doctor hired by self-insured organizations like Kaiser represents a lost premium.[15] There is no prediction whether this argument would hold in court. However, a resolution one way or another on this point will probably not be dispositive on the ultimate question of whether this merger will have anticompetitive effects. This is because even if purely self-insured entities are eliminated from the product market, there remain numerous companies competing in the medical malpractice insurance market in this state.

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[11] See *Tampa Elec. Co. v. Nashville Coal Co.,* 365 U.S. 320, 332 (1961), *citing Times-Picayune Pub. Co. v. United States,* 345 U.S. 594, 611 (1953).

[12] Internal TDC documents show that CAP-MPT has attained a market share of 10-12% in California.

[13] Compass-Lexecon letter to Commissioner Steve Poizner, May 20, 2008, p. 2.

[14] A risk retention group or "RRG" is a liability insurance company owned by its member insured, for the purpose of addressing their liability exposure. RRGs are formed under federal law, the Liability Risk Retention Act ("LRRA"). Once licensed, an RRG can insure members in all states.

[15] TDC has produced summarized data showing doctors lost to Kaiser. We assume that the data was compiled from company documents.

II. DISCUSSION

In merger analysis, the ultimate question is always about the creation or enhancement of market power. Market definition and market shares are a means to understanding the market power analysis, not an end in themselves. Thus, courts define markets and measure shares to understand the potential of a merger to create or enhance market power. In regulated industries, the Ninth Circuit has cautioned that "[r]eliance on statistical market share in cases involving regulated industries is at best a tricky enterprise...In such cases, the court should focus directly on the regulated firm's ability to control prices or exclude competition."[2] In addition, "[b]lind reliance upon market share, divorced from commercial reality, [can] give a misleading picture of a firm's actual ability to control prices or exclude competition."[3]

A. Relevant Market

1. Product Market

The seminal Supreme Court cases define product markets by the "reasonable interchangeability of use" or the "cross elasticity of demand" between the product itself and substitutes for it[4], which involves examining (1) the availability of substitute products, and (2) the degree to which customers are willing to switch to those substitute products.[5] The Court also teaches that the market "must be drawn narrowly to exclude any other product to which, within a reasonable variation in price, only a limited number of buyers will turn."[6] The central question is whether an increase in price for one product would cause enough buyers to turn to other products so as to make the price increase unprofitable.

Market definition should reflect market realities.[7] Courts look to customers' perceptions of the marketplace, the existence of special classes of customers who desire particular products and services, and the defendants' documents reflecting the "business reality" of "how the market is perceived by those who strive to profit in it,"[8] and industry or public perception of separate markets.[9] Finally, the market definition need not be perfect, as it is "always possible to take potshots" at a market definition[10]; the definition exercise should assist the Court in

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2 *Metro Mobile CTS, Inc. v. New Vector Communications, Inc.,* 892 F.2d 62, 63 (9th Cir. 1989).
3 *Id.*
4 See *Brown Shoe Co. v. United States,* 370 U.S. 294, 325 (1962).
5 *United States v. E.I. duPont de Nemours & Co.,* 351 U.S. 377, 400 (1956).
6 *Times-Picayune Publishing Co. v. United States,* 345 U.S. 594, 612 n.31 (1953).
7 *Metro Mobile CTS, Inc. v. New Vector Communications, Inc.,* 892 F.2d 62, 63 (9th Cir. 1989).
8 *FTC v. Coca-Cola Co.,* 641 F.Supp. 1128, 1132 (D.D.C. 1986), *vacated as moot,* 829 F.2d 191 (D.C. Cir. 1987)
9 *See United States v. Grinnell Corp.,* 384 U.S. 563 (1966); *Brown Shoe,* 370 U.S. at 325, *Olin,* 986 F.2d at 1299, 1302-03; *Rothery Storage & Van Co., v. Atlas Van Lines,* 792 F.2d 210, 218 n.4 (D.C. Cir. 1986) ("industry or public recognition of the [market] as a separate economic unit matters because we assume that economic actors usually have accurate perceptions of economic realities").
10 See *United States v. Rockford Memorial Corp.,* 898 F.2d 1278, 1285 (7th Cir. 1990).

2. Geographic Market

As a matter of law, the relevant geographic market in an antitrust case is "the area of effective competition...in which the seller operates, and to which the purchaser can practicably turn for supplies."[16] In determining the relevant geographic market, a determination of the sources and locations where the customers of the merging parties readily turn for their supply of the relevant product, including the merging parties and other sources of supply[17]. Here, evidence from internal documents and interviews with doctors' groups and insurance brokers show that California doctors buy medical malpractice insurance or its equivalence from companies inside and outside of the state. The relevant geographic market at issue here, therefore, is the United States, not simply California.

3. Appropriate Measure of Market Shares

At issue here is whether market shares based on the number of physicians served as opposed to premium volume is the most appropriate measure of market shares for purposes of calculating HHIs. At this point, our office cannot comment on the appropriateness of using market shares statistics based on number of physicians served. Ultimately, this is a question probably best answered by an industry economist. Compass Lexecon explained in their White Paper that market share statistics based on premiums written may be misleading because they exclude relevant competition and may be higher or lower depending on the risks and/or mix of physicians.[18] We concur that market share statistics based on premiums written may be misleading in this case because they exclude relevant competition from non-regulated alternative risk vehicles. But whether the magnitude of the change in market shares due to different risks and/or mix of physicians, such that it would make market share statistics based on premiums written completely unreliable, is an open question.

If the number of physicians served is the more appropriate measure for calculating market shares in this case, then the combined post-merger market share of TDC and SCPIE would be roughly 22%, as explained in TDC's white paper.[19] This is below the minimum market share required to exercise market power.[20]

B. Analysis of New Submissions

1. Data of Excessive Rates Charged by TDC and SCPIE

There is data from CDI showing that in 2006 and 2007, both TDC and SCPIE

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[16] *Tampa Elec. Co. v. Nashville Coal Co.* 365 U.S. 320, 327 (1961).

[17] *National Association of Attorneys General Horizontal Merger Guidelines*, section 3.2.

[18] See White Paper at 7.

[19] See Margaret Guerin-Calvert and Jonathan Orszag, "Economic Analysis of the Proposed Acquisition of SCPIE Holdings, Inc. by The Doctor's Company," February 2008 ("White Paper").

[20] See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 7-8, 26 (1984) (30% market share below threshold for market power, as a matter of law); *Rebel Oil Co. v. Atlantic Richfield* Co. 51 F. 3d 1421, 1438 (9th Cir. 1995) (following *Jefferson Parish* on this point).

experienced reduced losses (from claims and defense costs) but continued to charge their approved higher rates instead of requesting a rate decrease from CDI in order to better compete in the market. The data also seems to show that California medical malpractice premiums are increasing while losses incurred by the industry as a whole are decreasing. Yet, despite the current environment of lower losses incurred, the data showed only one rate-decrease filing in the 2007-2008 time frame from a dental malpractice insurance company.

The issue becomes, in light of the above data, whether post-merger, a combined TDC-SCPIE will have the ability to exercise market power based on the inference that they had the ability to charge excessive rates in the recent past. If this were the case in which TDC and SCPIE were the only companies who failed to file for a rate decrease in an environment of decreased losses in the industry, then arguably under California law[21], an inference can be made from the evidence that TDC and SCPIE have exercised market power and would be able to do so post-merger.[22] However, the data showed that not only TDC and SCPIE took advantage of industry-wide lowered losses, but just about all medical malpractice insurance companies failed to file for rate decreases. Therefore, a court would probably hesitate in inferring the post-merger exercise of market power from such data.

Nevertheless, to the extent that TDC and SCPIE charged excessive rates under the current regulatory scheme, then a remedy can be fashioned short of rejection of the entire filing by imposing conditions, including rate filings and rate roll-backs to protect California consumers.

2. CAOC Submissions

CAOC is an organization of 3,000 lawyers representing those injured, including those injured by medical malpractice. The only "evidence" that CAOC brought forward are 1) market share statistics that may be unreliable because they do not include non-regulated firms that compete in the medical malpractice insurance market[23]; 2) "excessive profits" in the California medical malpractice market for the last nine years,[24] which is not a reliable criteria in analyzing whether a merger would substantially lessen competition; and 3) the existence of high entry barriers into the California market because the only new entrant into the market has only attained approximately 4% market share.[25]

CAOC's argument regarding entry barriers bears addressing here because this is a key determinant as to whether TDC's acquisition of SCPIE would substantially lessen competition. "The thrust of the low entry barrier claim is not that competition cannot be 'substantially

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[21] There are no cases directly on point on this issue.

[22] See *Cellular Plus, Inc. v. Superior Court of San Diego County*, 14 Cal. App. 4th 1224, 1241-42 (1993) (consumers have a cause of action under the Cartwright Act for treble damages due to price fixing by against cellular telephone companies, even if the fixed prices had been approved as reasonable by a regulatory agency). It is doubtful that such an inference is permissible under federal law because antitrust claims in general are barred if a regulatory body is involved. See *County of Stanislaus v. Pac. Gas and Elec. Co.*, 114 F. 3d 858, 866 (9th Cir. 1997).

[23] See February 29, 2008 letter of Roger C. Brown & Associates to Steve Poizner, p. 3.

[24] *Id.* at p. 3-5.

[25] *Id.* at p. 5.

lessened,' but rather that a substantial lessening of competition will not produce as substantial or as durable an effect as if entry barriers were higher."[26] The defendant must show that entry would be timely, likely, and of sufficient magnitude to prevent a significant exercise of market power.[27] Also, "[a] firm is not likely to enter a market for which it lacks the capital, technical resources, marketing channels, or skills."[28]

The evidence here reveals that this is an industry with low entry barriers. Any medical malpractice insurance company that wishes to do business in this state must only obtain a license from CDI. RRGs compete with medical malpractice insurance companies without having to submit to regulation. Typical insurance contracts are for a period of one year and renewable at the option of the insured; physicians can always comparison-shop for the best rates after their contracts expire. There is no indication that TDC and SCPIE have locked up the market with multi-year contracts, denying competitors the necessary marketing channels to effectively compete. CAOC argues that there has been little entry into California, but it ignores the growing competitive significance of CAP-MPT and nascent entries of other RRGs cited by TDC[29]. In addition, data showing a steady decrease of medical malpractice insurance companies in California since 1998, in which there were approximately 69 companies, to 38 companies in 2006, is not probative of high entry barriers. A court can reasonably conclude that the steady increase of medical malpractice insurance companies from 1991 and subsequent decrease as more probative of the industry cycle of entries and exits over the years.

CAOC has not presented any reliable evidence that this merger would result in the merged firm's ability to exercise market power. In contrast, our office reviewed this acquisition based upon interviews with doctors' groups, insurance brokers, regulators, and competitors; we looked at confidential internal company documents from TDC and SCPIE, as well as public and private CDI data. We have taken the facts gathered in our investigation and applied them to present antitrust principles to arrive at our conclusion.

III. CONCLUSION

Based on the above discussion, this office continues to believe that TDC's acquisition of SCPIE would not substantially lessen competition under relevant antitrust principles. We do think, however, that to the extent TDC and SCPIE have been charging "excessive rates" under the present regulatory standards, then CDI can and should impose conditions upon the merging parties in order to protect California consumers.

c.c. Kathleen Foote
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[26] *See* Areeda & Hovenkamp, Antitrust Law para. 941b (Supp. 2004).
[27] See *Rebel Oil Co. v. Atlantic Richfield Co.*, 51 F. 3d 1421, 1440-41 (9th Cir. 1995).
[28] Areeda & Hovenkamp, Antitrust Law para. 1128c4 (Supp. 2004).
[29] May 20, 2008 letter at p. 4.